ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Nakano	Analyst:	LuAnna Hass	Bill Number:	AB 273
Related Bills:	See Legislative History	Telephone:	845-7478	Introduced Date:	02-16-2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: First-Time Homebuyer Mortgage Insurance Deduction

SUMMARY

This bill would allow a first-time homebuyer to claim the amount paid for private mortgage insurance (PMI) as a deduction.

PURPOSE OF THE BILL

The author's office has indicated that the bill's purpose is to give taxpayers an incentive to purchase their first home by providing a tax benefit to first-time homebuyers that elect to provide a smaller down payment and pay PMI.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal and state laws generally allow an itemized deduction for home mortgage interest. Certain miscellaneous itemized deductions (excluding home mortgage interest) are limited and may be claimed only to the extent that they exceed 2% of the taxpayer's adjusted gross income (AGI). Also, itemized deductions may be further limited for high-income taxpayers.

Current federal and state laws do not allow a deduction for private mortgage insurance.

THIS BILL

This bill would allow a first-time homebuyer to claim as an itemized deduction an amount equal to the amount paid or incurred during the taxable year for PMI for each year until 20% of the mortgage has been paid.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Gerald H. Goldberg	03/27/01
____ SA	____ O	____ NAR		
____ N	____ OUA	__X__ PENDING		

By reference to the Health and Safety Code, this bill would define "first-time home buyer" as a person who is a purchaser of an owner-occupied housing unit. The purchaser may neither have nor had a present ownership interest in a principal residence for the three years prior to the date the mortgage is executed.

The deduction allowed by this bill would be claimed with other miscellaneous itemized deductions and would be deductible only to the extent that the total miscellaneous itemized deductions exceeds 2% of the taxpayer's AGI.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The term "PMI" is undefined. It is unclear what specific types of insurance payments qualify for the deduction. The federal "Homeowners Protection Act of 1998" provides a definition for PMI. The author may wish to use that definition in this bill. However, the federal definition excludes Mortgage Insurance Protection (MIP) required for certain Federal Housing Authority (FHA) loans.

The definition of first-time homebuyer in the Health and Safety Code is linked to laws within the same code relating to mortgages issued by city and county housing agencies. Consequently, the buyer of a home financed with a mortgage obtained from some other source would not qualify for the deduction.

The bill uses the term "first-time home buyer" as defined in the Health and Safety Code. It is defined as a person who purchases an owner-occupied housing unit. The person may not own or have owned a principal residence during the **three-year** period prior to the date a mortgage governed by provisions of the Health and Safety Code was executed. However, current federal and state tax laws define the same term with the requirement being the **three-year** period prior to the date of acquiring a principal residence.

In addition, the term "principal residence," as used in the Health and Safety Code is not clearly defined. The term "principal residence" for federal and state tax purposes means property owned and used by a taxpayer as the taxpayer's principal residence. It may be confusing for taxpayers to have different definitions of the same terms being used for tax purposes.

This bill specifies that the deduction would cease for the taxable year when 20% of the amount of the mortgage becomes paid. However, it is the author's intent that the deduction would cease when equity has reached 20% of the original value of the property. This bill should be amended so that it is clear that the term "amount" does not refer to loan interest or principal.

Calculating the equity percentage may be confusing to taxpayers. Since federal law requires that PMI terminate when equity in the home reaches 22%, the author may wish to remove the reference to the 20% figure so that the deduction is available as long as PMI is paid (which will cease by law at approximately the same time as the 20% figure provided in the bill).

This deduction may be complex for taxpayers to calculate since it would be included as part of the taxpayer's miscellaneous itemized deductions and deductible only to the extent that they exceed 2% of AGI.

LEGISLATIVE HISTORY

SB 109 (Knight, 1999/2000), introduced December 15, 1998, failed passage in the Senate Revenue and Taxation Committee. SB 109 was identical to this bill.

PROGRAM BACKGROUND

PMI is a type of insurance that protects lenders against losses from foreclosure. This protection is provided by private mortgage insurance companies and allows lenders to accept a down payment that is less than the normal 20%.

PMI can be paid on either an annual, monthly, or single premium plan. Premiums are based on the amount and terms of the mortgage and will vary according to loan-to-value ratio, type of loan, and amount of coverage required by the lender. Under an annual plan, an initial one-year premium is collected up front at closing, with monthly payments collected with the mortgage payment each month thereafter. Monthly plans allow a borrower to pay the lender only one or two months' worth of premiums at closing, with the balance paid on a monthly basis with the regular mortgage payment. Homebuyers can choose to add the amount of the lender's mortgage insurance premium (which is a percentage of the loan balance) to the loan amount. By doing this, homebuyers can reduce their closing costs and increase their interest deduction.

Under federal law, a borrower is authorized to initiate the cancellation of PMI once a consumer has accumulated a 20% equity position in his or her home. This equity position is determined according to the amortization of the loan, including any prepayments, or upon the borrower establishing that the property’s value increased sufficiently to provide the borrower with a 20% equity position. Automatic termination of PMI is mandated at the 22% equity level for loans closed after July 29,1999. For loans closed before this date, a borrower can usually cancel PMI once there is sufficient equity in the home. For termination purposes, the point at which the 22% equity level is reached may be determined by payments made according to the initial amortization schedule. The only condition on this requirement is that the borrower must be current on all payments due on the loan at the time PMI is terminated. If the borrower is delinquent, PMI must be terminated as soon as the borrower becomes current.

OTHER STATES’ INFORMATION

Review of Illinois, Massachusetts, Michigan, Minnesota, and New York laws found no comparable tax deduction or credit. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

Once the implementation concerns are resolved, this bill would not significantly impact the department’s costs.

ECONOMIC IMPACT

Tax Revenue Estimate

Based on limited data and assumptions discussed below, this bill would result in the following revenue losses under the PITL.

Estimated Revenue Impact of AB 273 As Introduced 2/16/01 [$ In Millions]		
2001-02	2002-03	2003-04
-$1	-$1	-$1

The bill would be effective with taxable years beginning on or after January 1, 2001, with enactment assumed after June 30.

Tax Revenue Discussion

The amount of deductible PMI premiums (premiums that exceed the 2% of adjusted gross income threshold) and marginal tax rates of taxpayers with deductible premiums would determine the revenue impact of this bill.

According to industry contacts, there are roughly 5.2 million PMI policies in force nationwide. Nearly half of these policies are attributed to first-time homebuyers. Assuming that:

- California's distributive share of PMI policies is roughly equal to the number of owner occupied homes in California versus the nation, or approximately 10%;

- an average monthly premium of $75;

- deductible premiums are roughly 9% of total premiums paid by first-time homebuyers (see discussion below); and

- an average marginal tax rate of 6%;

revenue losses would be on the order of $1.1 million.

As a miscellaneous itemized deduction, PMI premiums would be included with other miscellaneous itemized deductions, if any, and would be deductible only to the extent they exceed 2% of adjusted gross income. PMI premiums paid by first-time homebuyers in California are projected at roughly $220 million annually. By using personal income tax sample data and a series of assumptions as a proxy, deductible premiums are projected to be on the order of $20 million annually.

PMI can be paid on a monthly, an annual, or a single premium plan. Premiums are based on the amount and terms of the mortgage and will vary according to loan-to-value ratio, type of loan, and amount of coverage required by a lender. The average PMI policy is in force for less than five years.

ARGUMENTS/POLICY CONCERNS

By allowing a deduction that is not allowed by federal law, the bill would create a state/federal difference that requires adjustments to income, thereby increasing the complexity of California tax return preparation.

This bill would allow the deduction even if the first-time homebuyer purchases a house outside California.

A first-time homebuyer with a mortgage through a city or county housing agency would qualify for this deduction. If the same homebuyer refinances the original mortgage for the sole purpose of lowering the interest rate, and consequently is no longer required to pay PMI, they would no longer qualify for the deduction.

LEGISLATIVE STAFF CONTACT

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